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Agenda Item 4a

March 15, 2011

TO: MEMBERS OF THE HEALTH BENEFITS COMMITTEE

I. SUBJECT: AB 36 (Perea) – As Amended February 18, 2011
State Tax Conformity for Dependent Care Coverage up to Age 26

Sponsor: Author

II. PROGRAM: Legislation

III. RECOMMENDATION: Support

IV. ANALYSIS:

The bill conforms State tax law to federal tax law by excluding from an employee's gross income for State personal income tax purposes, the value of employer-provided health coverage (incurred on or after March 30, 2010) for a child who, at the end of the taxable year, has not attained age 27. It also allows parents to exclude from their gross income, any reimbursements for medical expenses made under a flexible spending arrangement.

<u>Background</u>

On March 23, 2010, major federal health reform was enacted when President Barack Obama signed into law the Patient Protection and Advocacy Act (PPACA). The President later signed the Health Care and Education Reconciliation Act (HCERA) on March 30, 2010, which amended PPACA. Among their provisions was the extension of health care coverage for children up to the age of 26 under their parents' health benefit plans, regardless of whether they qualify as dependents for tax purposes. The passage of State legislation later that year, SB 1088 (Price), brought California into compliance with the federal laws extension of health benefits coverage to this group of young adults.

As a result, the CalPERS Board of Administration took action to implement these provisions, effective January 1, 2011, and took steps to inform members and employers that:

- The limiting age for their children's coverage under CalPERS health plans had been extended from age 23 to age 26;

- This new group of eligible children could be enrolled, even if they are married, did not live with the subscriber, and regardless of their student status;
- Enrollment would occur during the annual Open Enrollment period, with a coverage effective date of January 1, 2011.

To date, CalPERS has enrolled over 28,000 previously ineligible young adults into their parents' health plans.

While SB 1088 brought California into compliance with the federal law's new limiting age for the coverage of adult children, it did not address how the benefit would be treated for State tax purposes. Under federal law, a personal income tax exemption is provided to health plan participants that enroll their newly-eligible adult children. AB 1178 (Portantino), which would have brought State tax law into conformity with this federal exemption, as well as many other provisions of federal tax law, was held in the Senate Appropriations Committee due to its potential General Fund costs.

As a result, California is not in alignment with federal law as it relates to taxation of these newly-eligible adult children. CalPERS has informed members and employers that they may be required to report additional State tax withholding on this employee health benefit, and advised them to review guidance provided by the California Employment Development Department (EDD) and the Franchise Tax Board (FTB), and to consult their tax advisor.

<u>Proposed Changes</u>

Among other things, AB 36 amends State tax law to:

1. Exclude from the employee's gross income the value of employer provided health coverage, under an accident or health plan, for the employee's child who, as of the end of the taxable year, has not attained age 27.
2. Allow a parent to exclude from his or her gross income, any reimbursements under a flexible spending arrangement, for medical expenses incurred by the parent for the medical care of his or her child who, as of the end of the taxable year, has not attained the age of 27.
3. Apply these changes to expenses incurred and benefits provided on or after March 30, 2010.
4. Take effect immediately as a tax levy.

Legislative History

2010 Chapter 660 (SB 1088, Price) – Conforms with federal health reform law, by prohibiting the limiting age of dependent health coverage from being less than 26 years of age, with specified exceptions. The limiting age determines when children are no longer considered dependents for the purposes of health coverage. Under federal law the extension of dependent coverage is effective for plan years on or after September 23, 2010. *CalPERS Position: None*

AB 1178 (Portantino) – Would have allowed for conformity with federal health reform law by granting a federal tax exemption for eligible dependents up to the age of 26. This bill was held in the Senate Appropriations Committee. *CalPERS Position: None*

Issues

1. Arguments in Support

According to the author:

"With an estimated 1.2 million young adults between the ages of 19-25 uninsured, many young adults find themselves without medical coverage. By conforming California's tax laws to federal standards, the State creates an affordable health insurance option for the large pool of uninsured young adults in California. Although SB 1088 allows parents to add their adult child to their health care plan, the cost of non-conformity may become a tax burden some families may not be able to afford. By conforming California's tax laws to federal standards, the State ensures many more young adults are insured and their parents are not burdened by additional taxes as a result."

Supporters add: ". . . the added administrative and financial burden on employers in attempting to calculate the taxable amount attributable to the adult child would be eliminated with the passage of AB 36."

Organizations in Support: AFSCME; Aaron Read & Associates, LLC; Butte County Board of Supervisors; California Association of Health Plans; California Association of Psychiatric Technicians; California Chamber of Commerce; California Hospital Association; California Labor Federation; California School Employees Association Cal-Tax; Livermore Valley Joint Unified School District; Merced County Board of Supervisors; Spidell Publishing Inc.

2. Arguments by those in Opposition

There is currently no known opposition.

3. Employer Tax Compliance Burden

Since California has not conformed to the federal tax provisions related to the extension of health-care benefits to adult children, California employers have the added burden of determining how much wages to withhold from an employee who receives the benefit. Many employers first realized the difference in federal and State income treatment when preparing W-2s for 2010 when they were unable to locate any guidance from the State. As a result, employers not only had the task of dealing with calculating the appropriate amount of State reportable wages, but also anticipating what the proper State withholding should be. CalPERS employers do not yet face this problem because the Board did not extend dependent coverage until the beginning of 2011.

Without immediate State tax conformity, CalPERS, State agencies, and over 1,100 participating school districts and local agencies (along with other California employers) face the task of computing and reporting the tax liability for this extended dependent coverage. This will necessitate changes to enrollment and payment systems which could prove costly. CalPERS administrative burden is specifically tied to: identifying retired CalPERS members, who are California residents and have elected to provide health coverage under PEMHCA to their newly eligible adult children; identifying the “fair market value” of the benefit provided to that child; calculating the taxable benefit; identifying the proper withholding amount; and reporting these amounts, on their annual tax statements; and transmitting those additional taxes to the Employment Development Department.

4. Additional Tax Liability on Parents

The additional tax liability parents may face as a result of State non-conformity could total a substantial amount, upwards of hundreds of dollars, depending on the method used to calculate their tax liability and the number of children they continue to cover or newly-eligible children they choose to resume coverage. Since computation of the taxable amount is unclear and individual circumstances vary, determining the total financial burden on participating parents is difficult to estimate. However, the added financial strain of the State taxing this benefit could dissuade parents from providing health care to their uninsured adult children.

5. Difficulties in Computing the Tax

At this time, there is no statutory guideline mandating the method for determining the taxable amount, and the administrative guidance for employers and individuals issued by the Employment Development Department (EDD) and the Franchise Tax Board (FTB) only specify that tax will be owed on income equal to the amount by which the "fair market value" of the taxable benefit received by an employee, exceeds the amount the employee pays for the benefit. The EDD has further specified that the "fair market value" of the health care coverage is set at the discretion of the employer and that it is the employee, and not the adult child, that owes the tax.

To illustrate the problems this guidance presents, CalPERS health plans offer three health premiums: single party; two-party; and family, which provides health care coverage for three or more dependents. Since premium increases resulting from adding a dependent do not necessarily equal the premium increases resulting from adding a subsequent dependent, and adding a dependent when a parent already has family coverage does not increase his or her insurance premium, regardless of what an employer determines the "fair market value" of this benefit to be, the tax consequences will vary greatly from participant to participant.

If AB 36 is enacted to provide full state conformity to federal law that excludes the value of health coverage provided to newly-eligible adult children from gross income subject to taxation, CalPERS and other public and private sector employers will not be faced with the continuing challenge of determining the "fair market value" of the benefits they provide, and calculating the tax owed by their employees.

6. Board Legislative Policy

Board Legislative Policy recommends support of proposals which give the Board increased flexibility in its administration, and proposals which correct structural deficiencies in program design. AB 36, by providing State tax conformity to the federal tax exemption for parents that provide health coverage for their newly eligible adult children, reduces CalPERS administrative burdens, and reduces costs for members that elect to provide health care coverage to those children.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Costs

Unknown, but potentially significant benefit cost savings to members no longer required to pay State personal income tax on these dependent health benefits.

Administrative Costs

This bill could significantly reduce potential administrative costs for CalPERS and its employers because the employer would no longer be responsible for identifying impacted employees; calculating the amount of taxable benefit income; and reporting that taxable income on the W-2s and 1099s.

The longer California goes without tax conformity, the greater the administration burden is for CalPERS and its employers, especially for addressing employee and member questions on taxation.

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